No. 22366

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Metropolitan Savings and Loan Association, a corporation, and Fidelity Service Corporation, a corporation,

Appellants,

vs.

Williams Construction Co., a corporation, and A. J. Bumb, Receiver,

Appellees.

APPELLANTS' OPENING BRIEF.

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I.

STATEMENT OF JURISDICTION.

This is an appeal from a decision of the United States District Court for the Central District of California (hereinafter called "the Court below") on the review, pursuant to 11 U.S.C.A. §67(c), of orders of a referee in bankruptcy. The Court below had jurisdiction pursuant to 28 U.S.C.A. §1334 which provides that

> "District Courts shall have original jurisdiction . . . of all matters and proceedings in bankruptcy."

Jurisdiction over the instant appeal is conferred upon this Court by 11 U.S.C.A. §47 which provides that courts of appeal

> "are invested with appellate jurisdiction from the several courts of bankruptcy in their respective jurisdictions in proceedings in bankruptcy, either interlocutory or final, and in controversies arising in proceedings in bankruptcy, to review, affirm, revise, or reverse, both in matters of law and in matters of fact . . . ."

The Appellants herein seek to have this Court reverse the decision of the Court below affirming certain orders of the referee in bankruptcy [C. T. p. 162].

II.

STATEMENT OF THE CASE.

Appellants herein, Metropolitan Savings and Loan Association (hereinafter referred to as "Metropolitan") and Fidelity Service Corporation are the Beneficiary and Trustee respectively of a deed of trust on an R-1 Zoned 40-acre tract of land near Walnut in Los Angeles County (hereinafter sometimes referred to as "the land") of which Respondent Williams Construction Company (hereinafter referred to as "Williams") is the Trustor and owner. The deed of trust secures payment of a promissory note in the principal amount of $1,075,200.00 which matured on November 1, 1965 [R. T. p. 4, line 25, to p. 5, line 9; Exs. A and 5]. The land was acquired by Williams, a speculative builder, in 1963 for the purpose of constructing a housing tract [R. T. p. 123, line 2, to p. 126, line 18], was originally subdivided into 129 lots twenty of which have been sold, and now consists of 109 lots [R. T. p. 125, lines 7-11].

On September 1, 1965, the note secured by the deed of trust became delinquent for failure of Williams to

make the required payment and on September 30, 1965, Metropolitan caused to be recorded a "Notice of Default and Election to Sell Under Deed of Trust" [C. T. p. 68, line 30, to p. 69, line 25; Ex. G; see Section 2924a, California Civil Code].

On January 27, 1966 (approximately four months after the notice of default was recorded), when a trustee's foreclosure sale was imminent, Williams filed a Debtor's Petition in Chapter XI and an "Application to Stay Deed of Trust Foreclosure Proceedings and Trustee's Sale"; and, on the same day, an "Order to Show Cause Upon Application to Stay Court Action and Foreclosure, and Temporary Restraining Order" was issued [C. T. pp. 5-6]. Thereafter, a receiver in bankruptcy took possession of the land and joined in the application to restrain Metropolitan's foreclosure [C. T. pp. 13-14].

The order to show cause came on for hearing on September 1, 1966, before a referee in bankruptcy; the hearing was continued from time to time until September 30, 1966 [R. T. p. 1, lines 19-20; p. 206, line 1; p. 274, line 1; p. 445, line 1].

The alleged basis of the debtor's and receiver's application to restrain foreclosure was that there was a realizable equity in the land which should be preserved for the benefit of unsecured creditors. At the hearing, the receiver called three witnesses to testify regarding the value of the land. The first witness, Sam Jonas, stated that after examining the land for approximately half a day and checking into comparable sales for half a day, he had formed the opinion that the average value of the lots was $12,500 each [R. T. p. 15, lines 13-24; p. 24, lines 12-23]. A second witness, Eleanor Sam-

uels—the broker who had originally sold the tract to Williams—testified, over the objection of Metropolitan, that she thought the lots could be sold for about $12,000 to $18,000 each [R. T. p. 105, lines 3-7]. She pointed out, however, that expenses for promoting the sales at this price would have to be incurred [R. T. p. 116, line 11, to p. 117, line 2]. Williams, the owner of the lots, then testified that he thought the lots were worth from $14,000 to $16,000 "depending upon when they are sold, the terms upon which they may be sold and to whom they are sold" [R. T. p. 150, lines 3-24]. All of the witnesses apparently based their opinions upon the assumption that the sales would take place over a period of time and that the lots would be sold on an individual basis; none of the estimates would apply if the lots were sold as a tract [see *e.g.* R. T. p. 32, line 25, to p. 33, line 4; p. 35, line 16, to p. 36, line 1].

In resisting the application, Metropolitan established that its deed of trust was a "blanket" deed of trust on the entire tract; that the only provision therein for releases of individual lots from the lien thereof (which sometimes is called the right to partial reconveyances) expressly conditioned such right to partial reconveyances upon (1) the obligation being current, and (2) the obligation not having matured [Ex. 5]; that there had been a default under the deed of trust since September 1, 1965—approximately one year [Ex. G]; that the obligation matured on November 1, 1965 [Ex. A]; that the total indebtedness as of September 30, 1966 was $999,317.00, and that amount increased by $188.94 per day [R. T. p. 222, line 16, to p. 224, line 20]. Metropolitan then introduced expert testimony that the fair market value of the 109 lots, if sold as a tract,

would be $924,630.00 [R. T. p. 310, lines 6-10], and offered to prove the following:

> "Mr. Belin: Mr. Diedrich would testify, as he already has, that he is in the business of buying and developing and selling property; that about a year ago he talked with Mr. Kollie and was told that Metropolitan might foreclose and might have the property available and would give it to him on a 100 per cent financing basis for about $8,500.00 a lot; that he went to the property, looked at it and determined that, as a business man in this business, he didn't think the property was worth this for his purposes, namely, buying all 109 lots at that particular wholesale value, and he would explain the reasons as to why he doesn't think it is worth that." [R. T. p. 373, lines 6-20].
>
> * * *
>
> "Mr. Belin: I will offer to prove that the opinion [of the expert witness] would be that the fair market value [of the lots if sold as a tract] is not in excess of $8,000.00 or $8,500.00." [R. T. p. 408, lines 19-22].

Both offers of proof were rejected by the referee [R. T. p. 373, lines 21-22; p. 408, lines 23-24].

Thereafter, the referee entered "Findings of Fact and Conclusions of Law" that included, *inter alia,* the following:

> "That the fair market value of the property on September 30, 1966, is $1,362,500.00;[1]
>
> "That there is a substantial equity of the debtor in the said property.
>
> * * *

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[1]The finding of value was based upon a sale of the land on a lot-by-lot basis [C. T. p. 70, lines 2-9].

> "That a restraining order should issue restraining the Fidelity Service Corporation as Trustee, and Metropolitan Savings and Loan Association as Beneficiary, under that certain deed of trust executed on March 25, 1965, recorded on March 31, 1965 from proceeding with its foreclosure until further order of Court." [C. T. p. 4, lines 6-16].

On November 23, 1966, an "Order Restraining Foreclosure Proceedings" was filed, and on December 2, 1966, Metropolitan filed a "Petition for Review" of said order [C. T. pp. 47-48; pp. 49-52].

During the course of the proceedings referred to above, the receiver filed another application—this one seeking an order authorizing him to sell the land free and clear of the lien of Metropolitan [C. T. pp. 19-20]. An "Order to Show Cause" was issued [C. T. p. 22] and Metropolitan filed an "Answer to Application to Transfer Lien of Respondent to Proceeds" in which it referred to the deed of trust and the fact that the obligation secured thereby was both delinquent and past the date of maturity, and alleged and contended that by reason of these facts:

> ". . . no sale of [the land] or any portion thereof can be made free and clear of the lien . . . created by the aforesaid deed of trust . . . unless the net proceeds of such sale are sufficient to discharge, satisfy, and pay in full the entire indebtedness owing and to be owing to Respondent under the aforesaid deed of trust . . . which said sum as of September 30, 1966 was the sum of $996,317.00 plus interest thereon at the rate of $188.94 per day." [C. T. p. 31, lines 17-25].

The order to show cause came on for hearing on November 28, 1966. On January 17, 1967, the bankruptcy court entered "Findings of Fact and Conclusions of Law", which contained, *inter alia,* the following:

> "That an order should be entered herein authorizing the receiver to sell said lots separately, free and clear of all encumbrances, and that such liens be transferred to the proceeds of such sales" [C. T. p. 7, lines 7-10];

and entered an "Order Re Application to Transfer Lien to Proceeds" [C. T. pp. 72-73].[2] On January 24, 1967, Metropolitan filed its "Petition for Review" of said order [C. T. pp. 80-83].

On January 31, 1967, pursuant to stipulation of the parties, the Court herein entered an order which consolidated the petitions for review of the two orders for review and hearing by this Court.

The petitions for review came on for hearing before the Court below in June of 1967. On September 18 the Court handed down a "Memorandum Opinion" expressing the view that the action of the referee in bankruptcy in ordering the sale of the land on a lot-by-lot basis free and clear of Metropolitan's lien was correct [C. T. pp. 157-160], but containing no direct reference to the order restraining Metropolitan from foreclosing its deed of trust. A few days later, however, on September 22, 1967, it corrected the omission by entering an order confirming the "Order Restrain-

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[2]The order itself does not specify that the sales shall be free and clear of Metropolitan's lien. However, it is obvious from the Application and the Findings that this is its intent.

ing Foreclosure Proceedings" dated November 23, 1966, and the "Order Re Application to Transfer Lien to Proceeds" dated January 17, 1967 [C. T. pp. 184-185].

On September 27, 1967, Appellants filed a timely "Notice of Appeal" from the September 22, 1967, order.[3]

III.
SPECIFICATION OF ERRORS.

The fundamental error of both the referee in bankruptcy and the Court below stems from their apparent failure to comprehend both the nature of and limitations upon the power of a bankruptcy court as regards secured creditors, and the seriously prejudicial effects upon Metropolitan of the orders in question. What these orders do, in effect, is sacrifice the immediate legal remedies and interests of a secured creditor in exchange for a problematical expectation of effecting future improvement in the position of the unsecured creditors and, ultimately, of Williams.

More specifically, the District Court erred in:

(1) Finding that the bankruptcy court had the power to order that lots subject to Metropolitan's deed of trust be sold separately, free and clear of Metropolitan's lien, thus depriving Metropolitan of some of its security and transforming the character of the remainder from a tract of substantially contiguous lots sub-

[3]Appellants had earlier, on September 21, 1967, filed a "Notice of Appeal" from the "Memorandum Opinion"; but when it became evident that the September 22 Order was intended to constitute the final ruling on the Petitions for Review, the Appellants filed the September 27 notice.

ject to a planned development on an integral basis to an aggregation of lots not subject to such development, and impairing Metropolitan's substantive right to the repayment of principal at the maturity of the loan;

(2) Finding that the debtor had an equity in the land;

(3) Finding that the action of the bankruptcy court in entering the orders in question would not cause substantial injury to Metropolitan.

IV.

SUMMARY OF ISSUES AND ARGUMENT.

Technically, there are two separate ultimate issues before this Court:

(1) Whether the order of the referee in bankruptcy restraining Metropolitan from foreclosing its deed of trust should be reversed;

(2) Whether the order of the referee in bankruptcy authorizing the receiver to sell the lots separately, free and clear of Metropolitan's lien, should be reversed.

Practically, however, these issues are interdependent. Unless the lots can be sold on an individual basis, as provided in the order permitting a sale free and clear of Metropolitan's deed of trust, there is no equity in the property, and thus no justification for restraining Metropolitan from foreclosing its deed of trust. On the other hand, once the restraining order was vacated, Metropolitan would presumably foreclose and the sale order would be a nullity.

In Metropolitan's view, the issues before the Court, and Metropolitan's position thereon, are as follows:

A. Can the Lots Subject to Metropolitan's Deed of Trust Be Sold Separately, Free and Clear of Metropolitan's Lien?

The 109 lots which are involved in these proceedings are subject to a single or blanket deed of trust in favor of Metropolitan. A trustor has no right to secure the release of any portion of the security subject to a blanket deed of trust, except as provided therein, until the discharge of the indebtedness which it secures. In the instant case the only provision in the deed of trust pertaining to partial releases of security expressly conditions the trustor's right to such releases upon the note not being in default and not being mature. Yet the note had been both in default and mature for over a year when the Court ordered the lots to be sold separately, free and clear of Metropolitan's lien.

It is well established that a receiver in bankruptcy has no greater rights with respect to secured creditors than was enjoyed by the owner. Since the trustor, Williams, could not obtain the release of separate lots from the lien until the indebtedness which it secures had been discharged, neither can the receiver.

The reliance of the Court below on the rule that a bankruptcy court may prescribe the procedure by which a secured creditor realizes upon his security, provided that such procedure is as adequate and efficient as that of which the secured creditor would otherwise avail itself, is misplaced.

First, the procedure provided by the bankruptcy court does not even approach the required standard of ade-

quacy and efficiency. Under the terms of its deed of trust Metropolitan can effect an immediate liquidation of its claim through foreclosure under power of sale. Under the bankruptcy court procedure the foreclosure process would be drawn out over a number of years. Compelling it to retain a delinquent loan of approximately $1,000,000 for this period of time would have seriously prejudicial consequences to Metropolitan.

Second, nothing in a bankruptcy court's power to prescribe the foreclosure procedure permits a bankruptcy court to deprive a secured creditor of the specific security for which it contracted. Yet in the instant case the effect of the order that the subject lots are to be sold on an individual basis free and clear of Metropolitan's lien would be to deprive Metropolitan of, and to transform the fundamental character of the remainder of, that security.

Finally, Metropolitan does not merely have the right to the repayment of a sum of money at some indefinite point in the future; rather, it made Williams a loan for a limited period of time—and *only* for a limited period of time. When the loan matured it was entitled to the repayment of principal and accrued interest. What the referee in bankruptcy has done is to rewrite the loan contract between Metropolitan and Williams to transform it from an eight-month loan payable on maturity to a loan for the duration of the contemplated sales program repayable as lots are sold.

B. Is There an Equity in the Land Which Can Be Realized by the Receiver?

In a situation such as that involved here a secured creditor may be restrained from foreclosing its deed of

trust only if there is an equity in the land realizable by the receiver, and the burden of establishing the existence of such an equity is upon the applicants for the restraining order.

Metropolitan submits that it is apparent from the evidence upon which the restraining order was based that there is no realizable equity in the land. The undisputed evidence demonstrates that the amount realizable from a sale of the lots as a tract is less than the amount owing to Metropolitan. A sale of the lots separately, subject to Metropolitan's deed of trust, is obviously unfeasible because each lot would be subject to an encumbrance of many times its value. The only other alternative, a sale of the lots separately, free of Metropolitan's lien, is precluded since, as a matter of substantive law, no portion of Metropolitan's security may be released from its lien in the absence of a payoff.

C. Will the Order Restraining Foreclosure of Metropolitan's Deed of Trust and the Order That the Lots Be Sold Separately, Free and Clear of Metropolitan's Lien, Cause Metropolitan Substantial Injury?

Regardless of the question of whether the bankruptcy court may order a partial reconveyance of security when not authorized by the deed of trust or the existence of a realizable equity in the security, the bankruptcy court may not make orders such as those in question when their implementation will result in substantial injury to a secured creditor. Here such substantial injury is clearly present.

V.

ARGUMENT.

1. Metropolitan's Deed of Trust Upon the Land Is a Blanket Lien Under the Terms of Which Williams Is Not Entitled to Any Reconveyance Until the Obligation Which It Secures Has Been Paid in Full. The Rights of the Receiver to Such Reconveyance Are No Greater Than the Rights of Williams.

Under California law, a trustor has no right whatever to a partial reconveyance of the property subject to a deed of trust in the absence of a provision in the deed of trust which allows such reconveyance:

> "Certainly, if the mortgage had contained no release provision there could have been no pretense on their [the mortgagors'] part that they were entitled to have any of the mortgaged premises freed from the mortgage lien." [*Bradbury v. Thomas,* 135 Cal. App. 435, 442 (1933)].[4]

When a deed of trust does provide for partial reconveyances, the trustor is entitled to such reconveyances only when he complies with the conditions therefor prescribed in the deed of trust.

> *Bradbury v. Thomas,* 135 Cal. App. 435, 441-443 (1934);

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[4]It is well settled that for purposes of the Bankruptcy Act, the rights and obligations of the parties to a deed of trust are determinable by reference to local law. *In re American Motors Products Corporation,* 98 F. 2d 774, 775 (2d Cir. 1938); *Arnold v. Phillips,* 117 F. 2d 497, 500 (5th Cir. 1951). The local law governing this issue is obviously, in view of the many and obvious contacts between this controversy and California, the law of California. In any event, however, the California law on this question appears to be the same as that which prevails throughout the United States. See Corpus Juris Secundum, Mortgages, §479.

Davies v. Union Trust Co., 125 Cal. App. 593, 601 (1932);

Ontario Land and Improvement Co. v. Bedford, 90 Cal. 181, 184 (1891);

Conley v. Porvay Land and Inv. Co., 232 Cal. App. 2d 22, 25 (1965).

The *Bradbury* case, for example, involved a mortgage upon lots which, like the deed of trust herein, specifically provided that the mortgagors were entitled to the release of a portion of the security upon the payment of a specified amount in reduction of the loan, *provided that the mortgagors were not then in default under the mortgage.* The mortgagors paid the specified amount at a time when, although no default had been recorded, the mortgagors were delinquent in their payments. The court held that the mortgagors, despite their payment, had not satisfied the default condition and therefore were not entitled to the release of any lots from the mortgage:

> "The ordinary meaning of the word 'default', when used with respect to an obligation created by contract, is failure of performance. When used with reference to an indebtedness it means simply non-payment.
>
> * * *
>
> "Appellants occupy the position of mortgagors who are seeking to quiet their title against a mortgagee without paying or offering to pay the debt for which the mortgage was given. This they may not do. The only method for them to quiet the mortgage is to pay the debt which it secures [citing cases]." (135 Cal. App. 443, 445).

The facts of the instant case are immensely stronger than those in *Bradbury*. Rather than a mere technical noncompliance with a required condition, there was a total absence of the safeguards which Metropolitan and Williams had agreed would have to exist before any portion of the land could be released from Metropolitan's lien. The only provision in the deed of trust dealing with partial releases expressly conditions the trustor's rights to such releases upon the note not being delinquent or mature [Ex. 5]. Yet, at the time of the entry of the order in question, the note was both delinquent and mature and, in fact, a notice of default had been recorded for more than a year [Ex. G]. Furthermore, because the ninety day loan reinstatement period prescribed by statute had run [Civil Code Section 2924(c)], the indebtedness evidenced by the note secured by Metropolitan's deed of trust was irrevocably accelerated. It is abundantly clear that, under the circumstances of this case, Williams could not be entitled to force Metropolitan to release any portion of the security which forms the subject matter of its deed of trust.

Does the receiver herein enjoy any greater rights, vis-a-vis Metropolitan, than the trustor? The answer is no. In the absence of a specific statutory provision to the contrary, a trustee in bankruptcy acquires no greater interest in property than belonged to the bankrupt:

> "Under the provisions of the bankrupt act (sic), the trustee in bankruptcy is vested with no better right or title to the bankrupt's property than belonged to the bankrupt at the time when the trus-

tee's title accrued" [*York Mfg. Co. v. Cassell,* 201 U.S. 344, 352 (1905)];

". . . the trustee takes the property of the bankrupt . . . as the debtor had it at the time of the petition, subject to all valid claims, liens and equities" [*Zartman v. First Nat. Bank,* 216 U.S. 134, 138 (1910)];

"A trustee in bankruptcy cannot acquire a greater right or interest in the bankrupt's property than that which belonged to the bankrupt" [*Martin v. New York Life Ins. Co.,* 104 F. 2d 573, 574 (1939)].

Cases stating this proposition are legion. See, *e.g.,*

Stone v. Mondie, 157 F. Supp. 929, 930 (D.C. Okla. 1957);

Christensen v. Felton, 322 F. 2d 323, 327 (9th Cir. 1963);

Woodmar Realty Co. v. McLean, 294 F. 2d 785, 793 (7th Cir. 1961), *cert. den.* 369 U.S. 802;

In re German, 193 F. Supp. 948, 953 (D.C. Ill. 1961).

It has been applied with respect to many types of assets:

Insurance:

Frederick v. Fidelity Mut. Life Ins. Co., 256 U.S. 395 (1921) (Failure of trustee to comply with provision in policy requiring that the insured give insurance company timely notice of intent to change beneficiary and secure consent of officer of company thereto held to preclude recovery by trustee of cash surrender value of policy).

In re Grant, 21 F. 2d 88 (D.C. Cir. 1927) (Trustee entitled to recover cash surrender value of policy in which right to change beneficiary was reserved to bankrupt, but had no claim to cash surrender value of policy in which right to change beneficiary not so reserved).

Property sold under Conditional Sales Contract: *Kagan v. Industrial Washing Machine Corp.,* 182 F. 2d 139 (1st Cir. 1950) (Trustee in bankruptcy had no greater rights against conditional vendor to title to washing machine sold under conditional sales contract than did conditional vendee).

Contracts Limiting Use:

In re Spitzel & Co., 168 Fed. 156 (D.C. N.Y. 1909) (Trustee in bankruptcy bound by provisions of contract with manufacturer requiring resale of goods at a fixed price).

Most important of all for purposes of the instant case, the trustee in bankruptcy has no greater right against the mortgagee with respect to mortgaged property than was enjoyed by the mortgagor.[5]

In re American Motor Products Corporation, 98 F. 2d 774, 775 (3rd Cir. 1938);

In re Durst, 44 F. Supp. 486, 488 (D.C. Iowa 1942);

Hoehn v. McIntosh, 110 F. 2d 199, 201-202 (6 Cir. 1940);

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[5]Moreover, in this case, it is not even a trustee who has succeeded to the title of the bankrupt that is involved. Rather, it is a receiver who has only possession of the property in question and no title whatever.

In re North Atlantic & Gulf S.S. Co., 204 F. Supp. 899, 903 (D.C. N.Y. 1962).

In the *American Motor* case, the mortgage provided that if the mortgagee

> "retains counsel for the purpose of collecting any monies which may be due under the mortgage . . . [mortgagor] agrees to pay counsel fee, the amount of which is hereby expressly fixed at a sum which shall be equal to 15% of the balance due and unpaid under this mortgage. . . ." (98 F. 2d 775).

Upon the bankruptcy of the mortgagor and the taking of possession of the mortgaged property by the trustee, the mortgagee's counsel attempted to collect the amount due. The trustee in bankruptcy contended that it was not bound by the attorneys' fee provision in the mortgage, and that the mortgage lien "must be limited to what might be found fair and reasonable compensation for services necessarily performed." (98 F. 2d 774). The Court of Appeals, through a panel including both Judges Learned Hand and Augustus Hand, repudiated this contention. It pointed out that attorney's fee provisions were valid under local law, that the trustee took the mortgaged property subject to the lien, and that

> "in the absence of fraud or usury, a court may [not] substitute its own ideas of what would be just and fair to nullify the agreement of the parties to a contract." (98 F. 2d 775).

The instant case is one in which a referee in bankruptcy has substituted his own ideas of what would be "just and fair" and, in so doing, has sought to nullify the contract between the parties. The order of the ref-

eree authorizing the separate release of lots from Metropolitan's deed of trust is in clear and flagrant violation of the terms of that deed of trust. Metropolitan could have made 109 separate loans to Williams, each secured by a separate deed of trust upon one of the lots which is a part of said real property. But that was not done. Instead, the parties entered into a contract under which the *total* security was to secure payment of the *total* indebtedness; portions of the security could be released upon payment of a specified sum upon the indebtedness only prior to maturity of the loan and only when the loan was not in default.

The conditions for a partial release were not satisfied. Williams could not compel Metropolitan to release portions of its security, and neither can the receiver.

Why then, did the Court below find that the bankruptcy court was vested with the power to order the sale of individual lots free and clear of Metropolitan's lien? The answer is to be found in the following statement:

> "This Court is of the opinion that the powers of sale of the Referee are derived from the Bankruptcy Act, not by subrogation to the rights of the debtor under the deed of trust. While it is true that the rights of the trustee, or receiver, in the property are no greater than those of the debtor, it is well established that there may be a substitution of the remedy provided by the contract *without impairment to substantive rights so long as it is efficient and adequate* [citations]. In the instant case a judicial sale by the Bankruptcy Court has been substituted for the remedy of foreclosure by trustee's sale provided in the deed of trust.

> 'Everyone who takes a mortgage, or deed of trust, intended as a mortgage, takes it subject to the contingency that proceedings in bankruptcy against the mortgagor may deprive him of the specific remedy which is provided for in the contract." [citation] The determination of the manner of the sale, in lots or in bulk, is in the sound discretion of the Referee, and should be made so as to obtain for the property the highest possible price [citations]." [C. T. p. 158, line 29, to p. 159, line 21; emphasis added].

In other words, the Court below reasoned that the bankruptcy court has the power to prescribe the procedure by which a secured creditor realizes upon its security, and all that the orders here in question involve is the application of that power.

While such an analysis has an undeniable specious appeal, Appellants submit that it is nonetheless fundamentally erroneous.

First, the immediate remedy provided here is manifestly not adequate or efficient from Metropolitan's viewpoint. One of the critical considerations for virtually all secured creditors—and particularly a regulated lender such as a savings and loan association whose delinquent loans have a profoundly adverse effect upon its general business operation—is the time required for foreclosure. An immediate judicial sale is at least arguably an adequate remedy since it would permit prompt realization upon the security. But here the bankruptcy court contemplated a sales program extending over a number of years. To say that such a remedy is as adequate and efficient as that of which Metropolitan would otherwise avail itself is ludicrous.

Secondly, as the court below itself acknowledged—apparently without taking cognizance of the implications of its words—the powers of the bankruptcy court do not extend to affecting the *substantive* rights of the secured creditor, but only the *remedy* by which the secured creditor realizes upon his security. As stated by this very court in *In re Jersey Island Packing Co.,* 138 Fed. 625 (9th Cir. 1905):

> "Everyone who takes a mortgage, or deed of trust intended as a mortgage, takes it subject to the contingency that proceedings in bankruptcy against his mortgagor may deprive him of the *specific remedy which is provided for in his contract*" (138 Fed. 627; emphasis added).

The limited character of the bankruptcy court's powers was delimited in the subsequent decision of *Allebach v. Thomas,* 16 F. 2d 855 (4th Cir. 1927):

> ". . . the bankruptcy proceedings shall not effect the validity of the lien; but it nowhere says that this fact shall in any manner effect the *remedy to enforce the lienor's rights. The remedy may be altered without impairing the obligations of the contract,* so long as an equally adequate remedy is afforded" (16 F. 2d 855; emphasis added).

Similarly, in *Continental Bank and T. Co. v. Chicago etc. Co.,* 294 U.S. 648 (1934) the Supreme Court held that the action of a bankruptcy court in enjoining the sale of collateral pledged as security for loans was justified because:

> "It [the injunction] in no way impairs the lien or disturbs the preferred rank of the pledgees. It does no more than suspend the enforcement of the

> lien by a sale of the collateral pending further action . . .
> * * *
> "*It effects only the remedy*" (294 U.S. 676, 681; emphasis added).

Whatever the validity of the Court's analysis if the sale of the lots was to be effected on a simultaneous basis, in the instant case the lots were to be sold at different times over a number of years. Metropolitan is entitled, under California law, to have *the total security in its existing form* securing Williams' indebtedness to it so long as any portion of the indebtedness remains unpaid. Hence, the effect of the order that the lots could be sold separately, free and clear of Metropolitan's lien was not merely to substitute one remedy for another or to determine the details of the remedy prescribed by the bankruptcy court. Rather it was to deprive Metropolitan of (1) its right to the *total* security, and (2) of the particular security for which it had contracted.

At present the security consists of a tract of substantially contiguous lots capable of development on an integral basis and hence saleable to one interested in and able to engage in a development of this nature. As the order in question is carried out, however, the security will progressively lose its character as a tract and become more and more an aggregation of non-contiguous lots saleable in a different market to a totally different class of potential purchasers.

What the bankruptcy court is attempting to do, whether it realizes it or not, is tantamount to ordering that Metropolitan's lien be transferred from the security for which it contracted to some other security. Sup-

pose, for example, that included among Williams' assets was an oil refinery of a value equal to or greater than the value of the subject tract. Would the bankruptcy court be empowered to release the land from Metropolitan's deed of trust and substitute the oil refinery in its place? Clearly not.

Metropolitan has no assurance that the selling program contemplated by the bankruptcy court will be successfully consummated. If the receiver should elect to give up somewhere in the middle and permit Metropolitan to look to the lots for satisfaction of the remaining indebtedness to it, Metropolitan's only recourse would be to foreclose on a security which is different than that for which it initially bargained. Metropolitan submits that just as the lender who lends on a tract of lots may not be forced to accept an oil refinery in its stead, neither may a lender who lends on a piece of property subject to development as a tract be forced to look to an aggregation of non-contiguous individual lots left over after an unsuccessful sales campaign to satisfy its claim. For additional discussion of the effect of this order upon Metropolitan, see Section 3, *infra*).

Furthermore, Metropolitan's loan to Williams was not, under the terms of their agreement, to remain outstanding indefinitely. Rather, it was to have a duration of approximately eight months, commencing on March 25, 1965, and terminating on or before November 1, 1965 [Ex. A]. When November 1 came, Metropolitan was entitled to be repaid its principal and accrued interest.

The length of the loan was a matter of considerable importance both to Metropolitan and to Williams. Other considerations aside, it fixed the return which

Metropolitan could realize on the loan for the period of its existence, so that if interest rates rose Metropolitan would be precluded from putting out its money at a higher rate. It is not unlikely that had the duration of the loan been longer, the rate of interest which it bore would have been higher.[6]

What the referee has done here, in effect, is to rewrite the contract between Metropolitan and Williams to extend the loan from eight months to such period as may be required to sell off the lots. In other words, instead of an eight-month loan, Metropolitan now has a three, four or five-year loan.[7]

The fact, so heavily relied upon by the Court below, that presumably Metropolitan would receive interest during the entire period does not legitimate the orders in question. Suppose a tenant leases a building for one year at a fixed monthly rental. Can he insist upon remaining in the premises so long as he continues to pay that monthly rental? What Williams did in this

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[6]While the note does contain a provision that the loan was to continue to bear interest after maturity in the event that it was not paid off in accordance with its terms, this was merely designed to compensate Metropolitan for the use of the funds during the interim between maturity of the loan and foreclosure of the deed of trust. In no sense does it defer Metropolitan's right to repayment.

[7]Metropolitan, of course, recognizes that a bankruptcy court has the power to restrain a secured creditor from foreclosing its lien (see Section V. 2. *infra*). But this is only a procedural power enabling the bankruptcy court to preserve the *status quo* and prevent interference with the exercise of its jurisdiction. [See *In re Lustron Corp.*, 184 F. 2d 789, 794 (1950)]. Restraining a secured creditor from foreclosing its lien in order to give the bankruptcy court an opportunity to sell the debtor's equity in the property subject to the lien or arrange a judicial sale which will result in a prompt pay-off of the secured creditor is something far different from rewriting the loan so that the secured creditor is compelled to wait years for repayment.

case was to "lease" the use of a given sum of money for a given period. The "lease" has now expired and Metropolitan wants its money back.[8]

2. The Order Restraining Metropolitan From Foreclosing Its Deed of Trust Should Be Vacated Because There Is No Realizable Equity in the Property Subject Thereto to Be Preserved.

Metropolitan recognizes that the bankruptcy court has the power to restrain a secured creditor from foreclosing its lien on property in the possession of the bankruptcy court. This power is necessary in order to permit the court to discharge its obligations and prevent interference with its jurisdiction. *In re Jersey Island Packing Co.*, 138 Fed. 625 (9th Cir. 1905). Nonetheless, the court's power to restrain a secured creditor from foreclosing may be exercised only when to do so will secure some definite benefit for the debtor's estate—normally, the preservation of an equity. For the court to restrain foreclosure in the absence of

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[8]The outrageous effect of the order in question is somewhat obscured by the fact that Metropolitan is an institutional lender engaged in the business of lending money. Suppose, however, that the order in question applied not to Metropolitan Savings and Loan Association, who had lent Williams approximately a million dollars, but to a 70-year old widow who had lent him $10,000. Could it be reasonably contended that because she would be receiving interest on her loan during the entire period that the widow's substantive rights were not impaired by orders restraining her from foreclosing her security and requiring her to wait four or five years for the return of her money? Metropolitan submits that its position is no different. The widow may want the money to pay for an operation, to finance a grandchild through college, or even to lend to someone else. Metropolitan may want the money to refurbish its offices, to increase the salaries of its employees, or to lend to someone else. The point is that both have lent money for a particular period of time and both expect the money back at the end of that period.

a showing that there is a realizable equity in the encumbered property, or some other equally persuasive reason to do so, is an abuse of discretion.

> *Kimmel v. Crocker,* 72 F. 2d 599, 601 (10 Cir. 1934);
>
> *Bushong v. Theard,* 37 F. 2d 690, 692 (5 Cir. 1930).

In the instant case, the bankruptcy court's order restraining Metropolitan from foreclosing its deed of trust was predicated upon the finding that Williams, the debtor, had a substantial equity to be preserved [C. T. p. 69, lines 31-32], and unless Williams in fact has such an equity which is realizable for the purpose of the arrangement sought herein, no purpose whatever is served by restraining Metropolitan from foreclosing.

The burden of proving the existence of such an equity was upon the respondents and they have failed to meet it [Title 11 U.S.C.A. §714; *In re Tracy,* 194 F. Supp. 293 (1961)]. There is no reasonable prospect that any equity whatever can be realized from the sale of the subject property above Metropolitan's encumbrance thereon. There was absolutely no evidence adduced at the hearing before the referee that the lots, if sold as a tract, would produce a sum in excess of the obligation of Metropolitan's lien. Indeed, all of the evidence which was introduced indicated quite the contrary. Yet the only way in which, under the terms of the deed of trust binding upon the receiver, the bankruptcy court has the power to sell the lots free of liens is as a tract. A sale of the lots individually, subject to Metropolitan's lien, would obviously not be feasible; each lot would be subject to an encumbrance of approximately

one hundred times its value. A sale of the lots individually, free and clear of Metropolitan's lien, would impair Metropolitan's contractual rights and therefore is beyond the jurisdiction of the bankruptcy court to order [see Section V 1, *supra*]. In short, since the property cannot legally be sold for a sum which will produce an equity for Williams' unsecured creditors, the order restraining Metropolitan serves no valid purpose and its issuance was an abuse of the discretion of the bankruptcy court.

3. The Orders in Question Should Be Vacated Because Their Implementation Will Result in Substantial Injury to Metropolitan.

The arguments advanced in Sections V 1 and V 2 hereof compel reversal of the orders in question. But even if there were some realizable equity in the property to be preserved for the benefit of Williams' creditors, and even if a partial reconveyance of the land would not result in an impairment of Metropolitan's substantive contractual rights, the result of this review would still have to be the same for the reasons set forth below.

The bankruptcy court does not, in a Chapter XI proceeding, have the power to order a sale of property free of liens or restrain a secured lienholder from foreclosing upon his security when to do so would result in substantial injury to the lienor:

> "A Chapter XI proceeding may arrange only the rights of unsecured creditors, without alteration of the rights of secured creditors. . . . The Court has the power to restrain sale of the property in question under the deeds of trust, only if necessary

to facilitate the primary purpose of this proceeding, *and if it does not cause substantial injury to the lienor* [citation]." [*In re Tracy* (1961) 194 F. Supp. 293, 295; emphasis added].

". . . the power [to sell free of liens] will not be exercised unless it is made to appear that *there is a fair prospect of the property being sold for substantially more than enough to discharge the lien or liens upon it.* . . . The court must be satisfied that a sale will be to the interest of the general creditors and not injure the lienholders. . . ." [*Hoehn v. McIntosh,* 110 F. 2d 199, 202 (6th Cir. 1940; emphasis added)].

Let us consider the impact of each of the orders:

A. The Order Restraining Foreclosure.

Here, even assuming that the sales projection of Samuels and the other witnesses for the receiver were correct and further assuming that Metropolitan ultimately will recover every penny of interest and principal to which it is entitled under its note and deed of trust, nonetheless the injury to Metropolitan from the order restraining foreclosure will be substantial.

The Court of Appeals for the Seventh Circuit, in *In re Holiday Lodge, Inc.,* 300 F. 2d 516 (7th Cir. 1962), recently took cognizance of the adverse consequences to a savings and loan association which can flow from the prolonged restraint of a foreclosure proceeding:

"We are not unaware of the natural effect of a prolonged interference with a foreclosure proceeding brought by a savings association, such as appellant in this case. It amounts to a freezing

of assets, while it is in effect, a condition which is not consistent with that degree of liquidity requisite in any financial organization engaged in the acceptance of investment of the funds of many members of the public." (300 F. 2d 520).

Not specifically alluded to by the Court of Appeals, but of immense significance to Metropolitan as a savings and loan association, is the fact, of which the Court can take judicial notice, that the loan would constitute a "scheduled item", as that term is defined by appropriate governmental regulations,[9] for the period in question.

The avoidance of scheduled items is of primary concern to a savings and loan association for a variety of reasons. The ratio of scheduled items to the association's assets is commonly regarded as an index of financial strength, a high ratio tending to discourage investment in that particular association. It is no answer for that association to reply that it is restrained from disposing of the asset, or that the bankruptcy court found the loan to be adequately secured. The adequacy of security is of no moment where a loan is seriously delinquent; it is the delinquency itself which causes the item to be scheduled and it is the scheduling of the item which causes injury to the association.

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[9]Scheduled items" are defined by §561.15 of the Rules and Regulations for Insurance of Accounts of the Federal Saving and Loan Insurance Corporation as including, *inter alia:*

> "(a) Slow loans (other than insured or guaranteed loans . . .)".

"Slow loans", in turn, are defined in §561.16 of the aforementioned regulations, as including, *inter alia*:

> "(b) Any loan or land contract that is from 1 year to 7 years old and which is the equivalent of 90 days (three months) or more contractually delinquent . . ".

Another consequence of an asset becoming a scheduled item is that the savings and loan association's ability to borrow from the Federal Home Loan Bank Board—a vital source of its credit—is impaired. Federal Home Loan Bank Board Bulletin No. 168, dated January 13, 1965, provides:

> "Whereas the Board of Directors of this bank deems it advisable to establish a general policy regarding limitations to be applied by the bank with respect to lines of credit extended to the member institutions having a ratio of scheduled items to total assets of over 4 percent.
>
> "Resolved that credit for other than net withdrawal purposes to applicant members having scheduled items at a ratio of over 4 percent to total assets to be restricted as follows:

Ratio of Scheduled Items to Total Assets	Credit for Other than Net Withdrawal Purposes
Over 4% - 5%	14% of Savings
Over 5% - 6.5%	10% of Savings
Over 6.5% - 7.5%	7.5% of Savings
Over 7.5%	5% of Savings"

In other words, an association need only have scheduled items of four percent (4%) in order to have a limitation placed upon its capacity to borrow from the Federal Home Loan Bank Board. The loan which is the subject of these proceedings is one of approximately one million dollars. The consequences are obvious.

B. The Order Authorizing the Sale of the Lots Individually Free of Metropolitan's Lien.

The objection of Metropolitan to a sale free of its lien is based upon a great deal mort than a desire to preserve an abstract contractual right, significant though that may be; the fact is that the sale of the lots separately, free of Metropolitan's lien, will inflict upon Metropolitan grave and onerous burdens and risks.

In effect, the bankruptcy court's order fundamentally alters the character of the security. At the present time, the security for the indebtedness to Metropolitan consists of a tract of lots. A tract may be sold for development as an integrated community. The purchaser may wish to develop the tract in accordance with a uniform architectural style, or base the development upon a special pattern of land use, or do any number of things which can only be done with a tract and which becomes progressively less feasible as lots are sold off. Yet it is almost a certainty that, as the sales authorized by the Court's order proceed, the security will increasingly lose its character as a tract and, more and more, become an aggregation of individual lots. At some point, a sale of the property as a tract will be precluded.

It is true, of course, that this change in the character of the security will itself not cause detriment to Metropolitan if, in fact, all the lots are sold *and* sold for an aggregate sum sufficient to fully pay off its loan. But suppose that, at some point in the sales program,

it becomes apparent that the sale of the security will not produce a surplus in excess of the amount due to Metropolitan. The fact that a court reasonably finds that a property can be sold for an amount in excess of the lien upon it does not assure the secured creditor that it will be sold for such amount. *In re Beardsley,* 38 F. Supp. 799, 803 (D.C. Md. 1941). Should the receiver decide to abandon the sales effort and turn over the remaining security to Metropolitan, Metropolitan will have a security which it can no longer sell as a tract. It will be compelled to continue the liquidation proceeding on a single lot basis—at a time when, by the fact of abandonment, it is reasonably certain that a surplus cannot be realized and that, possibly, a loss will be sustained.

Moreover, it may very well be, and indeed probably would be, that the lots ultimately returned to Metropolitan would be the least desirable and least saleable in the tract. Metropolitan would then be in the position of having the balance of its indebtedness secured by the worst of the security—hardly either a fair or desirable situation.

In short, an analysis of the facts of this case in the light most favorable to Respondents compels the conclusion that any benefit which may be derived for the unsecured creditors from the orders in question will be at the cost of far-reaching and substantial injury to Metropolitan.

VI.

CONCLUSION.

For the foregoing reasons, Petitioners submit that the decision of the Court below should be reversed, with directions to vacate the referee in bankruptcy's order restraining Metropolitan from foreclosing its deed of trust and order authorizing the sale of the lots subject thereto free and clear of Metropolitan's lien.

Respectfully submitted,

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Certificate of Counsel.

I certify that in connection with the preparation of this brief, I have examined Rules 18, 19, and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

Aaron M. Peck